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Implementing indexation of the tax laws; Statement of tax policy 9

American Institute of Certified Public Accountants. Federal Taxation Division

Statement of Tax Policy

9

Implementing Indexation of the Tax Laws

AICPA

American Institute of Certified Public Accountants

Statements of tax policy of the federal tax division are issued for the general information of those interested in the subject. They present the conclusions of the division, which is the senior technical body of the Institute authorized to speak for the Institute in the area of federal income taxation.

Statements of tax policy are intended to aid in the development of federal tax legislation in directions that the division believes are in the public interest.

Statements of tax policy do not establish standards enforceable under the Institute's Code of Professional Ethics and are not intended for that purpose.

Statement of
Tax Policy

9

Implementing Indexation of the Tax Laws

Issued by the Federal Taxation Division of the
American Institute of Certified Public Accountants

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Foreword

This is one of several statements of tax policy issued by the AICPA Federal Tax Division on tax policy matters in which accountants have special competence. We hope the formal presentation of our position will help serve the public interest.

Statements of tax policy are approved by the executive committee of the AICPA Federal Tax Division after they are developed by the division's tax policy subcommittee. Other division subcommittees may develop policy statements if requested to do so. This statement was approved by the 1980-81 tax policy subcommittee and the 1980-81 executive committee.

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Background

Statement of Tax Policy 6, issued by the American Institute of Certified Public Accountants, states that the Institute supports the concept of indexing the Internal Revenue Code to adjust for changes in the value of the dollar. That statement presents the issues together with background information on the subject of indexation, including a summary of indexation abroad and in the United States and arguments for and against indexing.

As called for in Statement of Tax Policy 6, a new task force was established to study procedures for implementing indexation of the code. This Statement of Tax Policy results from those studies.

Recommendations

The AICPA recommends that the Internal Revenue Code be indexed to minimize the impact of inflation on the tax system. To implement this recommendation, the Institute specifically suggests that

1. Individual tax brackets and fixed dollar allowances such as deductions, credits, and exemptions be indexed.
2. Corporate tax brackets and fixed dollar allowances be indexed.
3. The basis of assets generally be indexed.
4. Assets and liabilities representing fixed dollar debt not be indexed.
5. A capital maintenance deduction not be provided for business enterprises.
6. Estate and gift tax brackets and fixed dollar allowances be indexed.
7. One readily accepted index be consistently used as the measurement of inflation.

Introduction

The U.S. economy has been subject to varying degrees of inflation during most of its history. In general, the annual rates of inflation have been relatively modest; consequently, inflation usually has not had a materially adverse effect on our tax system. However, increased worldwide inflation and recent double-digit inflation in the United States has challenged the credibility of our present tax system.

The sustained high level of inflation in recent years has convinced the public of the need to deal with inflation as more than a temporary phenomenon. Most economists, and the population as a whole, anticipate high rates of inflation into the foreseeable future. In our opinion, this mandates that Congress adjust and correct the tax system for inflation. The Institute neither supports nor opposes any particular tax rate structure or percentage exclusion for long-term capital gains. Our only objective in this statement is to preserve the congressionally determined structure from distortions due to inflation which arise after such determination. As discussed in Statement of Tax Policy 6, we have concluded that adjustment for inflation is needed and should be made by indexing the Internal Revenue Code.

Most of the basic provisions of the Internal Revenue Code were enacted at a time when inflation was not a serious problem; consequently, the major features of the code, such as income tax brackets which set marginal tax rates, and exemptions and deductions, are stated in fixed dollar terms. But inflation diminishes the real value of these items and unless they are adjusted, tax burdens will increase at a rate more than proportionate to inflation. This tax increase may be termed an *inflation tax*.[1]

The resulting increase in government revenues creates other serious economic problems which are discussed in this statement. Further, because federal income taxes generally are more progressive than state income taxes and because state income taxes generally are more progressive than related local taxes, there tends to be a greater flow of resources to higher levels of government, resulting in a distortion of fiscal balance among federal, state, and local entities. Finally, inflation creates distortion in the distribution of the total tax burden, especially against taxpayers at the lower end of the income scale.

1. Advisory Commission on Intergovernmental Relations, "The Inflation Tax: The Case for Indexing Federal and State Income Taxes" (Washington, D.C.: 1980), p. 1.

As the tax base (total pretax income) expands, federal revenues increase by a greater than proportionate amount. For example, the Congressional Budget Office estimates that without indexation, inflation will increase federal income tax revenues from individuals by over $22 billion in fiscal year 1981 alone.[2] A study conducted by the Joint Committee on Taxation showed that government tax revenues rise at 1.65 times the rate of increase in the cost of living. For individual taxpayers, this means that for every 10 percent rise in income, taxes increase an average of 16.5 percent. The difference represents the increase in federal revenues beyond the proportionate growth in income. The net effect is a tax increase resulting from inflation rather than from legislative action.[3]

Capital Formation

During periods of inflation, businesses have difficulty obtaining the capital necessary to modernize plant and equipment. Committing funds to the development of new inventions or business undertakings entails the acceptance of risks, but under our present system, the interaction of inflation and taxation diminishes the reward against which these risks are measured.

Many businesses seek to price their products and engage in activities so they can replace income-producing assets as they become worn or obsolete and earn a return on their original investment. If businesses underestimate the cost of replacing old assets, they will not have sufficient funds left over to finance expansion and new investments. It appears this has been happening. If one looks at the figures for the entire economy, unadjusted for inflation, business profits appear adequate to replace existing capacity while still leaving substantial amounts for new investment. However, when business costs are adjusted for inflation, real profits are seen to decrease greatly. The problem is made worse because taxes are imposed on income unadjusted for inflation, rather than on real economic profit. Thus, after adjustment for inflation, the pool of net savings available for new capital investment has been decreasing steadily.

The AICPA has addressed one aspect of capital formation in Statement of Tax Policy 7, *Analysis of Capital Cost Recovery Pro-*

2. Congress of the United States, Congressional Budget Office, "Indexing the Individual Income Tax for Inflation" (Washington, D.C.: 1980), p. X.

3. U.S., Congress, Senate, Committee on Finance, Hearing before the Subcommittee on Taxation and Debt Management Generally, 95th Congr., 2d sess., 24 April 1978, statement of Senator Robert P. Griffin.

posals (STP 7). As that statement noted, the simplest and most effective hedge against the erosion of investment caused by inflation is the immediate write-off of capital expenditure, so the tax benefits from invested funds are immediately available for further investment. The statement further concluded that, next to immediate write-off, indexing cost recovery allowances would provide the best hedge against inflation because it addresses the problem most directly and completely.

Statement of Tax Policy 7 made its final recommendations on the basis of three criteria. Inflation was one. The other criteria were the current need for investment incentives, and simplification. When all three criteria were considered, it was concluded that "the optimum solution would be to adopt the mechanics of the SCR [simplified cost recovery] system [the pooled asset accounting concept as embodied in H.R. 7015] but to modify the recovery approach so that, at least for tangible personal property, the tax benefits from depreciation would approach those under CCRA [Capital Cost Recovery Act—H.R. 4646 and S. 1435, also known as "10-5-3"]." These bills were introduced in the 96th Congress; the approaches they embody will be extensively debated in the 97th Congress.

The primary reason that indexation of depreciation was not chosen as the final recommendation of Statement of Tax Policy 7 was that it would create additional complexity in the tax code. This point was considered significant because it was thought that if indexation were adopted, "the present depreciation systems, such as ADR, would likely be continued with many of their inherent complications." Statement of Tax Policy 7 also concluded that the "complexity of indexation is usually overstated—sometimes greatly." The statement went on to note that "indexation techniques could be combined with other cost recovery proposals, including CCRA or SCR," and that indexation would become relatively more attractive if inflation became worse. Although no such proposal had been suggested at the time Statement of Tax Policy 7 was written, it is now recognized that a system of pooled accounts could be indexed and still provide considerable simplification.

Political Accountability

The inflation tax creates a tax increase in the absence of legislative action or public debate. Thus, the electorate cannot place responsibility for this increase in government revenues on any specific

group of elected officials. Often Congress has passed what were purported to be tax cuts, but these did nothing more than reduce the inflation tax. In the past decade, there have been several legislated tax cuts, yet the actual tax bill of most citizens, as a percentage of personal income, has increased rather than decreased.[4]

Unless tax increases are enacted, indexing the tax code would slow down the growth in government revenues, preventing them from increasing faster than inflation. Real increases in revenue would have to result from real economic growth, which would help maintain the division of resources between the public and private sectors. Also, real tax cuts would be clearly identified as such.[5] An indexed tax code would enable voters to identify responsibility for their taxes and to hold elected officials accountable for tax increases.

Conformity

Inflation can have a significant impact on the determination of income for both tax return reporting and financial accounting purposes. Until the past decade, when the rate of inflation rose rapidly, there had been little motivation or sense of urgency for either Congress, in the case of our tax laws, or the accounting profession, in the case of financial accounting, to develop techniques for determining the consequences of such impact. The accounting profession and the Financial Accounting Standards Board presently are examining the feasibility of adopting inflation-adjusted financial statements. Although no one definitive method has been adopted at this time, several have been suggested and two are currently being tested.

The courts have recognized that the purposes of financial statement reporting and income tax reporting are not the same.[6] While the primary goal of financial accounting is to provide useful information to management, shareholders, creditors, and other interested parties, the primary goal of the income tax system is the equitable collection of tax revenue. In addition, the income tax system is used to accomplish various social purposes mandated by Congress. Regardless of whether, or how, inflation adjustments are made for financial reporting purposes, indexation is necessary to maintain the credibility and equity of the tax system.

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4. *Ibid.*
5. "The Inflation Tax," p. 18.
6. *Thor Power Tool Co.*, 439 U.S. 522 (179), aff'g 563 F. 2d 861 (7th CIR. 1977) aff'g 64TC154 (1974).

Income Taxes

Individual Tax Brackets and Fixed Dollar Allowances

As inflation causes prices and incomes to rise, our progressive tax structure places taxpayers in higher marginal tax brackets, which results in their paying a greater portion of their income in tax to the federal government each year. This increase in tax beyond the rate of inflation is known as the *inflation tax*.

To illustrate this tax, consider the example of a family of four whose money income has increased from $15,000 to $16,500 to keep pace with one year of 10 percent inflation. Although the family's pre-tax purchasing power is the same—that is, its real income before taxes in economic terms has not changed—the family has jumped from an 18 percent marginal tax bracket to a 20 percent marginal tax bracket. In total, the family's federal income tax burden has increased from $1,242 to $1,530. The net result is an increase in tax liability of 23 percent, based on a money increase of only 10 percent and a decrease in after-tax real income.[7]

If the tax liability had risen at the same rate as inflation, 10 percent in our example, then the total tax liability would have increased only $124 (from $1,242 to $1,366) and neither the family nor the federal government would have had economic gain or loss because of inflation. Instead, the tax liability increased $288 (from $1,242 to $1,530). Although the family's income before taxes rose sufficiently to keep pace with inflation, the family now pays a larger portion of its income in taxes and its after-tax purchasing power is reduced by $164, the amount of the inflation tax.

If the family's money income had remained constant, the purchasing power of that income would have been reduced by inflation. Indexation would at least reduce the tax cost, thereby mitigating the loss of real income.

In conclusion, under an indexed tax code, the validity of a progressive tax structure would be maintained. There would continue to be greater tax liability at higher levels of income, but the increase in tax liability would result from increases in real income or purchasing power, not just from inflation, and the added tax associated with inflation-related increases in income would be eliminated.

Tax Equity

Inflation distorts the legislated distribution of the tax burden. Under the present system, inflation significantly increases tax liabil-

7. "The Inflation Tax," p. 2.

ities at all income levels, but the greatest burden is borne by lower-income groups. Indexing the tax code would maintain an equitable distribution of the tax burden by tying the tax base to real income, thus avoiding the shift in the tax burden caused by inflation. This would give greater credibility to the notion that our system of taxation really embraces an "ability-to-pay" concept.

For example, the tax increase generated by one year of 7 percent inflation is as high as 15.5 percent at the $15,000-level and as low as 11.1 percent at the $25,000-level. At this rate, the tax liability on $15,000 of real income will more than double by 1984. The disproportionate impact of the inflation tax on low-income families is presented graphically in Figure 1.[8] The tax increase caused by inflation is highest at the $10,000- and $15,000-income levels and declines gradually as income increases until the $35,000-income level, at which point it accelerates again.

There are really two components of the inflation tax that explain the disparity in the effect of inflation on various groups. First, inflation erodes fixed dollar amounts. Low-income groups are most affected by the loss in value of personal exemptions since their personal exemptions are larger in proportion to income. Also, low-income taxpayers generally do not itemize deductions. They usually use the zero bracket amount (formerly the standard deduction), another fixed dollar amount that is being eroded by inflation. Itemized deductions are more likely to be used by taxpayers at higher income levels.[9] Since itemized deductions are based on actual expenditures, they tend to increase with inflation. (To the extent this is so, itemized deductions are self-indexing.) Second, as income increases, taxpayers are placed in higher marginal tax rate brackets, a phenomenon known as "bracket creep." This is especially true if the relative width of the tax brackets narrows, as happens for taxable income between $20,000 and $45,000.

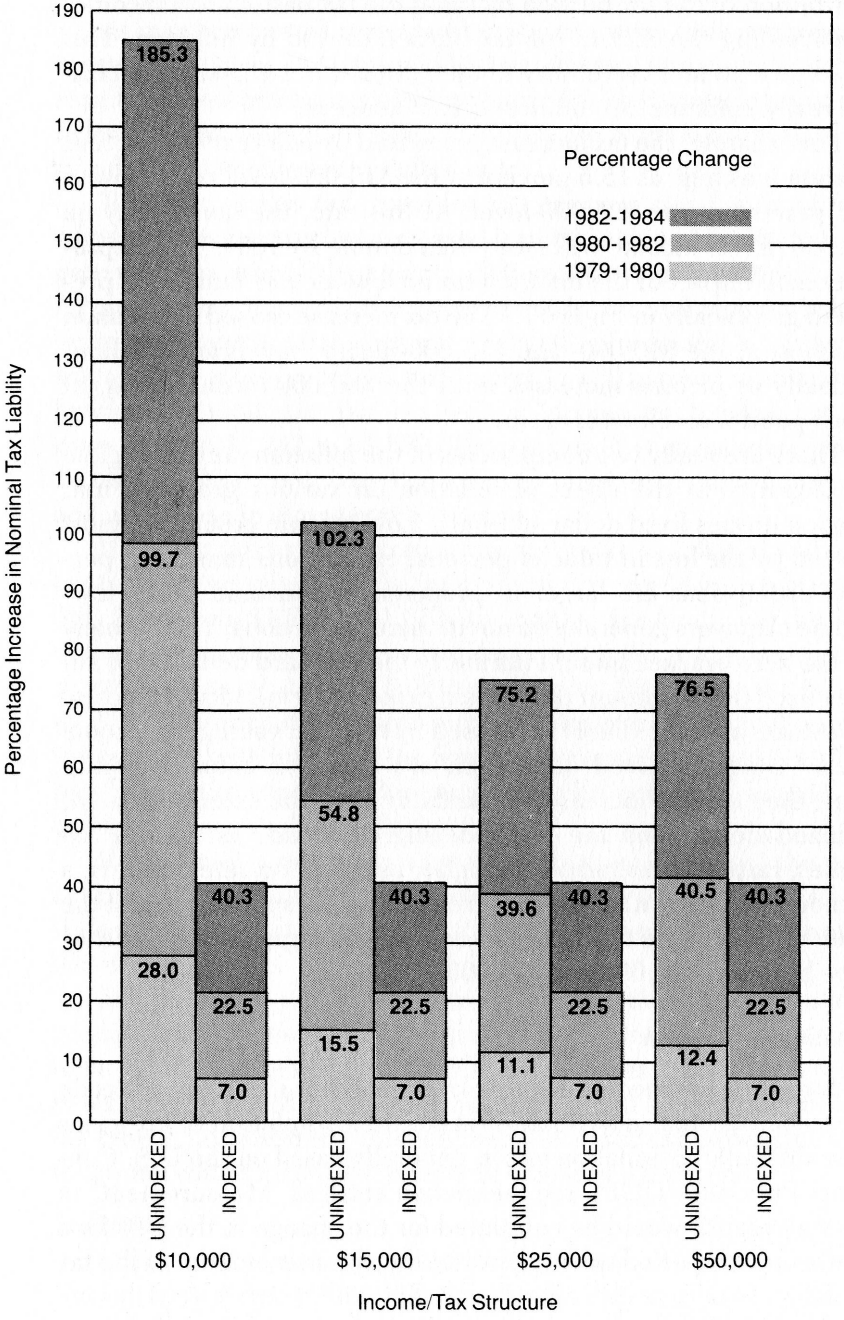
Indexing Tax Brackets

Indexing the income tax brackets need not make the tax code more complicated, nor would it make the completion of tax forms more difficult. An inflation factor, generally based on the U.S. Consumer Price Index (CPI, see the section entitled "Measurement" in this statement), would be computed for the change in the CPI for a twelve-month period ending prior to the commencement of the tax

8. *Ibid.*, p. 5.
9. *Ibid.*, p. 4.

Figure 1

How the Inflation Tax Affects Different Taxpayers



Source: The Inflation Tax: The Case for Indexing Federal and State Income Taxes.

year. Thus, the tax brackets in any particular year would be adjusted by the rate of inflation for the prior year. As of each January 1, the brackets should be known for such purposes as withholding and estimated tax payments. To allow sufficient time to calculate the inflation factor and publish new rate tables, the CPI for the twelve-month period ending with the third quarter of each calendar year should be used to adjust the rates of the succeeding year. This use of the third quarter CPI from the prior year would result in an inflation factor that is "lagged" by fifteen months.

Using the figures provided below as an example, the inflation factor would be determined in the following manner:

	CPI*
3rd Quarter, 1979	200
3rd Quarter, 1980	220
3rd Quarter, 1981	250
*CPI Base Year	1967 = 100

Assuming that indexation began in 1980 and using 1980 as the base year, the marginal tax brackets for 1981 would be determined by adjusting the 1980 marginal tax brackets by the percentage increase in the CPI from 1979 (200) to 1980 (220), which is 10 percent (20/200). Marginal tax brackets for 1982 would involve adjusting the 1980 marginal tax brackets by 25 percent (50/200).

The inflation factor would then be applied to the upper and lower boundaries of each marginal income tax bracket. For example, assume that during the base year taxable income between $6,200 and $7,200 is taxed at $450 plus 17 percent of the excess over $6,200. After the CPI has increased 10 percent, the marginal tax brackets would be adjusted so that income between $6,820 (110 × $6,200) and $7,920 (110 × $7,200) would be taxed at $495 (110 × 450) plus 17 percent of the excess over $6,820.

To avoid working with unwieldy amounts the revised figures should be rounded to the nearest hundred dollars. Since annual adjustments are made in terms of the base year and not the previous year, rounding errors would not be compounded.

If Congress decides to change the structure of the tax brackets, it could issue a new set of tax tables. These could then be indexed, with the year of enactment as the new base year.

Indexing Fixed Dollar Amounts

Indexing the fixed dollar amounts in the tax code is not conceptually or mechanically different from indexing tax brackets. The difference lies in the variety of fixed dollar amounts contained in the

code and the wide range of purposes they serve. Regardless of whether a single inflation factor or special purpose indexes are used, fixed dollar amounts must be indexed to alleviate the effects of inflation. The following is a representative listing of fixed dollar amounts contained in the tax code, with an explanation of the effects of inflation (measured by changes in the Consumer Price Index) from the dates these provisions were enacted through March 1979.[10]

Dividend Exclusion. Section 116, as amended in 1964, allows an individual to exclude $100 of dividends from gross income. Inflation effectively eroded 56 percent of the benefits of the provision. Accordingly, the exclusion is equivalent to $44 rather than $100.

Death Benefits. Section 101, introduced in 1954, excludes $5,000 of employee death benefits from gross income. This amount has never been revised, and inflation has effectively reduced the benefit of the exclusion by 62 percent (an effective exclusion of $1,900).

Fellowship Exclusion. Section 117, introduced in 1954, excludes from gross income $300 "per month" of fellowship grants received by a nondegree candidate. This exclusion has never been increased and the benefit has effectively been eroded by 62 percent (an effective exclusion of $114).

Group Term Life Insurance. Section 79, introduced in 1964, provides that an employee need not include in gross income the cost of $50,000 of group term life insurance provided by his employer. The amount has never been adjusted and is effectively reduced 56 percent by inflation to $22,000.

Casualty Loss. Section 165(c)(3), introduced in 1964, limits casualty losses of individuals to amounts in excess of $100. This amount has never been adjusted, resulting in a 56 percent effective reduction. Here inflation benefits the taxpayer using the provision.

Medical Insurance. Section 213(a)(2) has allowed a deduction of $150 for health insurance premiums since 1967. This amount has not been revised and has effectively been reduced 52 percent by inflation.

10. Kevin J. O'Brien and Jerry A. Menikoff, "Aspects of Indexing Taxes for Inflation" in *Tax Notes*, 21 January 1980, p. 59. Taxation With Representation Special Report, January 1980.

Moving Expenses. Beginning in 1970, Section 217(b)(3)(A) allowed a $1,000 deduction for certain moving expenses. This limitation was raised to $1,500 in 1977. In spite of that increase, inflation eroded 17 percent of the 1977 deduction.

Child Care Credit. For 1976 and thereafter, Section 44A allows a credit of up to $2,000 for child care expenses. Inflation has eroded the maximum benefit of this credit.

The inflation factor should be applied each year to the foregoing amounts, to the marginal tax brackets, and to such items as

- Personal exemptions.
- Zero bracket amounts.
- Limits on the amount of earned income eligible for the earned income credit.
- Limits on the amount of income eligible for the tax credits for the elderly.
- The $25,000 limit on the amount of tax that can be offset by the investment tax credit without regard to the present 70 percent limitation.
- The $10,000 exemption from the minimum tax.
- The $100,000 limit on the tax exempt gain from the sale of a home by a person age 55 or over.
- The $1,500 and $1,750 limits on annual contributions to an individual retirement account.
- The $7,500 limit on annual contributions to a self-employed individual's pension.
- The $3,000 limitation for capital losses which can offset ordinary income.

An inflation adjustment for items carried over and carried back could be provided. However, as discussed below, we believe that implementation of such an adjustment would create a substantial degree of complexity. Consequently, we do not recommend it at this time.

Income Tax Brackets and Fixed Dollar Allowances for Trusts and Estates

Trusts and estates are subject to income tax just as individuals are. We recommend that income tax brackets and fixed dollar

amounts for trusts and estates be indexed in the same way as for individuals.

Corporate Tax Brackets and Fixed Dollar Allowances

Corporate income is taxed at graduated rates, with a top marginal rate of 46 percent applied to taxable income over $100,000. Similarly, there are a variety of fixed dollar exemptions, limitations, tax credits, and so on that are applicable to corporations. For example, the accumulated earnings tax is levied at 27 percent on the first $100,000 of accumulated taxable income in excess of the accumulated earnings credit (which is presently $150,000) and at 38.5 percent on amounts in excess of $100,000. We recommend that corporate tax brackets and fixed dollar amounts be indexed in the same manner as for individuals.

Allowances for items carried over and carried back theoretically should be adjusted for inflation since they do not represent price levels current at the time taxes are paid. For example, net operating losses, investment tax credits, and foreign tax credits, which may be carried back or forward, could be adjusted to reflect the impact of inflation on their values. Although adjusting items carried over and carried back would be theoretically correct, such adjustments would create significant complexities. Therefore, we do not recommend such adjustments at this time.

Basis of Assets Generally

We consider inflation to be a sufficiently serious problem that in addition to indexing tax brackets and fixed dollar amounts, the tax basis of assets (with certain exceptions) should be indexed too. It should be noted that this concept was included in S. 2738, introduced in the U.S. Senate in 1978.[11]

It has been argued that indexation of basis is not necessary because of the 60 percent exclusion of long-term capital gains from taxable income. While we do not take a position at this time as to what exclusion should be allowed for capital gains, we believe that any such exclusion is neither an equitable nor an adequate manner of compensating for inflation. Despite the exclusion, taxpayers who have suffered a real economic loss often are subject to tax on the sale

11. S. 2738, 95th Congr., 2d sess., 1978 (bill not enacted).

of an asset. A simple example will illustrate the point. A 9 percent taxable gain on the sale or exchange of an asset in a year when inflation is 10 percent will result in an economic loss of 1 percent. Under our present tax structure, however, the taxpayer would be required to pay tax as if a 9 percent profit had actually been realized.

We are convinced that the complexity of indexing basis is usually overstated. It would not be difficult to have the adjusted basis of assets multiplied by an inflation factor. The newly calculated indexed basis would be used for determining gain or loss on disposition, as well as for calculating depreciation. The use of an indexed basis would result in the calculation of gain or loss on the sale of assets that would be consistent with the underlying economic effect.

In periods of rising inflation, businesses are unable to recover through depreciation sufficient funds to replace the assets being depreciated. Depreciation charges based on unadjusted historical costs are unrealistic when they are compared with current replacement costs. Further, when these assets are sold, inflation causes economic gains to be overstated. Inadequate depreciation allowances, combined with the taxation of inflated gains and the higher replacement costs of capital goods, limit the ability of businesses to internally generate the funds needed for capital outlays. As indicated in the introduction, the AICPA has published a separate booklet, Statement of Tax Policy 7, *Analysis of Capital Cost Recovery Proposals*, dealing with depreciation. We refer the reader to that study for our recommendations on how methods of cost recovery should be modified.

Under an indexed system of depreciation, the applicable depreciation method (either the straight-line or an accelerated method) would be applied to the indexed adjusted basis to calculate the taxpayer's depreciation deduction. Either current tax rules pertaining to depreciation or new ones could be applied. The system of open-ended or "pooled" accounts recommended by Statement of Tax Policy 7 is particularly suited to indexation because even with indexation this method of depreciation would be much simpler than the methods presently allowable for computing depreciation deductions. The indexation of basis would not affect the determination of the period over which capital costs would be recovered. Thus, the taxpayer could use an estimated useful life, the asset depreciation range system, or any recovery period set forth under a capital cost recovery program. Use of an indexed basis for calculating depreciation would make it possible to recover more than 100 percent of original cost through depreciation deductions.

For reasons described in the next section of this statement, we recommend that the basis of assets and liabilities representing fixed dollar debt (bonds, notes, payables, receivables, and so on) not be indexed. We recognize that there may be situations in which an asset that does not have a fixed dollar value is so supported by fixed dollar assets as to be virtually indistinguishable from them, such as a share in a mutual fund that holds only bonds. We are confident that legislation or regulations can be drafted to deal with such situations for which indexation of basis would not be appropriate.

Because of the complexity involved, we do not, at this time, recommend indexation for determining the gross profit from sales of inventory. Generally, the LIFO method of inventory valuation is available to associate current costs with current selling prices. On those occasions when LIFO fails to match costs (for example, when LIFO layers are invaded) there would be recognition of inflation-induced gains. To mitigate this problem, the AICPA is currently considering recommending a tax law change that would allow the reestablishment of eroded LIFO layers within certain limited periods of time.

Assets and Liabilities Representing Fixed Dollar Debt

The rate of interest negotiated between a lender and borrower represents the pure cost of money (the risk free interest rate) plus a premium for risk. The risk premium includes the anticipated rate of inflation. In recent years, inflation has become an increasingly important element in the interest rate structure. If, for example, the pure cost of money is 3 percent, lenders will be reluctant to lend money at 3 percent when the rate of inflation is 5 percent.

The rate at which the lender will loan money will also depend on the lender's tax rate because the lender is seeking to maintain his after-tax rate of return. If the lender's marginal tax rate is 50 percent, under stable prices, his after-tax rate of return is 1.5 percent. If inflation is 5 percent, the lender will seek to raise the before-tax rate of interest to 13 percent. This is determined by viewing the 13 percent as 6.5 percent after tax and then subtracting 5 percent for inflation, which in real terms is equivalent to earning 1.5 percent before inflation.

Thus, from the lender's point of view, the fluctuation of interest rates makes a separate adjustment for inflation unnecessary. If the borrower is in the same tax bracket as the lender (50 percent), he

will need no adjustment either. Under stable prices, the borrower had to pay 3 percent, but this was a deductible expense so that after tax the borrower's real cost was 1.5 percent. Now the borrower has to pay 13 percent interest, but this, too, is deductible, so that his after-tax interest expense is 6.5 percent. Since the borrower is repaying the loan with depreciated dollars, after subtracting the 5 percent rate of inflation the real cost of borrowing is 1.5 percent.[12]

To the extent that market rates of interest adjust for anticipated inflation, a tax adjustment for debt instruments is unnecessary. However, there are qualifications to this position. For example, there will be discrepancies and lags among nominal rates of interest, real rates of interest, and the rate of inflation. In recent times, the rate of inflation has not always been fully anticipated, as shown by declining market values of long-term bonds, savings and loan mortgage portfolios, and the long-term debt instruments held by various financial institutions issued at lower interest rates. In periods of inflation, the borrower repays long-term debt with "cheaper dollars," which in the view of some gives rise to an economic gain. However, this gain may be considered as offset by a loss to the lender. Therefore, looking at the economy as a whole, the determination of income is approximately correct.[13]

If creditors and debtors are not in the same tax bracket, any rise in interest rates can have redistributive effects. A recent study considers the inflation-induced distortions that emerge as corporate income passes through the corporate and individual tax systems.[14] This analysis concludes that the tax benefit resulting from the ability of corporations to deduct interest was slightly more than offset by the tax penalty suffered by the holders of the debt, since the effective tax rate for individual recipients of interest was slightly higher than the effective corporate rate.

Finally, institutional barriers prevent certain creditors from adjusting their rates of return for inflation. For example, laws set limits on interest rates that may be paid on savings accounts. These institutional barriers have resulted in disintermediation, whereby investment dollars have flowed to those instruments and institutions offering the highest rates of interest for a given level of associated risk.

12. Hearings on S. 2738, 95th Congr., 2d sess., 1978, statement by Emil M. Sunley, Deputy Assistant Secretary for Tax Analysis.

13. *Ibid.*

14. Feldstein, Martin and Summers, Lawrence, "Inflation and the Taxation of Capital Income in the Corporate Sector," Working Paper No. 312 (Cambridge, Mass.: National Bureau of Economic Research, 1979.)

The result is that the aggregate effect of those institutional barriers is offset as investors seek the highest returns available. In this connection, it may also be noted that Congress is addressing this issue of removing restrictions on interest rates on savings.

Although market adjustments will always be less than perfect, the theoretical and empirical evidence indicates that inflation is anticipated by lenders and borrowers so that gains and losses are, on the whole, substantially offset and the overall determination of net income is not affected. To create perfect adjustments would require a tax code that would be enormously complicated and impractical. The interactions of the free market result in rates of interest that sufficiently adjust to and anticipate the rate of inflation so that it is unnecessary to index the basis of fixed dollar assets and liabilities.

The Capital Maintenance Deduction for Net Worth

Some countries (most notably Brazil) that have experienced rates of inflation significantly higher than the United States have provided businesses with a capital maintenance allowance designed to compensate business enterprises for the eroded buying power of their equity.

Briefly stated, a capital maintenance allowance is a deduction or adjustment that applies the inflation rate to net worth as adjusted for nondepreciable and nonfinancial assets. Thus, the capital maintenance allowance would be calculated by comparing the beginning and ending net worth of a company after eliminating static assets, such as LIFO inventory, land, goodwill, or other fixed assets which are not adjusted for depreciation. The capital maintenance allowance could be determined at various points during the year or with beginning and ending averages. In a complex and changing economy, we believe that the difficulties in record keeping, administration, and calculation under a capital maintenance provision would outweigh the benefits that might result and therefore conclude that a capital maintenance allowance is not needed at this time.

Estate and Gift Taxes

In 1942, Congress determined that decedents with taxable estates valued at more than $60,000 should pay an estate tax and that persons who made gifts of over $30,000 during their lifetimes (ex-

cluding annual gifts of $3,000 or less to each individual donee) should pay a gift tax. At that time, these figures constituted Congress' view of a fair distinction between those who should and those who should not pay a tax on the transfer of their wealth.

From 1942 to 1976, as inflation eroded the value of the dollar, more and more of the population passed over those threshhold amounts. Some became relatively more wealthy, but others, such as wage earners and many farmers and small businessmen, crossed the threshhold only because it is defined in terms of the ever eroding dollar. Their income and assets stated in dollars had grown but their purchasing power had not grown proportionately. As a result, every year a greater number of individuals became subject to these transfer taxes.

When Congress acted in 1976 to reform the estate and gift tax provisions of the Internal Revenue Code, it did little to counteract inflation as a taxing agent. It left the annual gift tax exclusion at $3,000. It did abandon the $60,000 exemption from estate taxation, replacing it with a $47,000 credit against the tax (beginning in 1981). The credit is popularly referred to as the equivalent of an exemption of $176,000, but this is accurate only with respect to the lower end of the estate tax scale. For estates falling into the highest bracket, the $47,000 credit is the equivalent of only about a $67,000 exemption. Prior to the 1976 reforms, the $60,000 exemption reduced taxes by $46,200. Thus, the change did not adequately adjust for inflation. The reduction of the top estate tax bracket from 77 percent to 70 percent was not an adequate response to inflation either; rather, it was a trade-off for enactment of the unified transfer tax, the subsequently revoked carry-over of basis rule, and the generation-skipping transfer tax. The unified transfer tax not only raised the gift tax rates as high as those of the estate tax (prior to the 1976 reforms they had been three-quarters of the estate tax) but also provided that taxable gifts be drawn back into the tax base at the time of the donor's death. In addition, the scale of rates was shifted higher, and the top brackets are now reached more rapidly.

The reform legislation relaxed the tax burdens only in a few, selected areas. The smallest estates gained some relief from the new unified credit, the minimum marital deduction, and special valuation methods for real property used as a farm or in a trade or business. However, the limited relief available to these specific hardship cases is fast dwindling. In each case the relief was provided in fixed dollar terms: the $47,000 credit, the $250,000 minimum marital deduction, and the $500,000 maximum decrease of valuation for

qualified farm and small business real property. Consequently, as time passes, inflation shrinks the effectiveness of the relief. At an annual inflation rate of 10 percent, $350,000 in 1988 and $700,000 in 1995 will be needed to furnish the same purchasing power that $176,000 provides in 1981.

Congress ought to establish the level of real wealth that should be subject to the estate, gift, and generation-skipping transfer taxes, and this level should then be maintained by indexation. Inflation should not push individuals not previously subject to transfer taxes above the minimum level of taxation and then ever highter up the scale of transfer tax rates. In an indexed system, only a true increase in wealth would have this effect.

The estate, gift, and generation-skipping transfer tax provisions are readily subject to indexing in the same manner as income tax brackets and fixed dollar amounts. The upper and lower boundaries of each tax bracket and the credit for state death taxes can be modified annually by reference to cumulative changes in the CPI. In similar fashion, the applicable fixed dollar amounts may be adjusted for inflation. The inflation factor determined annually should be applied to amounts such as the following:

1. The unified credit against estate and gift taxes, and, to the extent available, against the generation-skipping transfer tax.
2. The $500,000 limit on decrease of valuation for qualifying farm or other trade or business real property.
3. The $500,000 limit on decrease in the value of the gross estate in recognition of material participation in a farm or other trade or business by the surviving spouse.
4. The $250,000 minimum marital deduction.
5. The orphan's exclusion, presently $5,000 for each year that a child is younger than twenty-one.
6. The annual exclusion of gifts up to $3,000 to each donee.
7. The limit of $5,000 upon the exclusion from gift taxation of a general power to appoint property.
8. The limit of $100,000 on excludable gifts to a spouse.
9. The $250,000 limit on excludable generation-skipping transfers.

In the case of estate and gift tax provisions, the due dates of the returns permit reference to CPI figures at the close of the calendar year rather than to those of the third quarter, as would be necessary for income tax purposes. Furthermore, we recommend no more

than annual adjustment. Although the taxes apply to transfers at particular moments in time, the reference to a figure which applies to an entire calendar year would be a simple process and would be sufficient to relieve the problem to which indexation is addressed.

No adjustments are recommended to the amounts of prior gifts or taxes paid thereon. Since these amounts generally are reciprocal their indexation would serve little practical purpose. Thus, only the unused portion of the unified credit would be indexed. This refers to amounts such as the following, which would not be indexed:

- The amount of adjusted taxable gifts taken into account in computing the tentative estate tax and the amount of the credit against the estate tax for gift taxes paid by the decedent.
- The aggregate sum of the taxable gifts and the gift taxes of preceding years taken into account in computing the gift taxes of a particular year.
- The amount of the credit against the estate tax for taxes paid on a prior transfer to the decedent.

Measurement of Inflation

The AICPA believes that the index used to measure inflation should be readily accepted by broad segments of society and should be capable of being consistently applied. Further, we support the use of a single general purpose index. Although arguments have been made that an indexation system should use different indexes for different items so that alternative indexes could be used for specific applications, we believe this would add complexity to the tax code.

An index such as the Consumer Price Index (CPI) would generally meet these requirements. The CPI is a widely used measure of inflationary pressures and of changes in the purchasing power of the consumer dollar. It is the most familiar index, and it is currently used in the Internal Revenue Code and by various states that have adopted indexed tax systems. In addition, among the countries that use indexation in their tax structures, nearly all make use of their equivalent of the CPI. While imperfect, the CPI generally reflects price changes for things people must buy in order to live—food, clothing, rent, household supplies, medical expenses, public utility rates, and so on.[15]

15. U.S., Department of Labor, *BLS Handbook of Methods for Surveys and Studies* (Washington, D.C.: Government Printing Office, 1976), p. 88.

All statistical surveys, by nature, lend themselves to possible inaccuracies, and the CPI as a general measurement of inflation has been criticized for a number of reasons. Shortcomings of the CPI may arise from inaccurate reporting, lack of systematic incorporation of new outlets into the sample, and introduction of new products or changes in product quality.[16] It should also be noted that the CPI has not been developed for use in measuring nonconsumer price level changes.

However, the public generally considers the CPI the official government indicator of inflation. It has widespread use in wage and collective bargaining negotiations. An index based on the CPI is used for Social Security payments and for fixed dollar limitations for defined benefit plans and defined contribution plans.

In conclusion, we believe that a single generally accepted and consistently applied index should be used. Whatever index is selected, it is important that it be continually monitored and adjusted to reflect changes in the economy.

16. Edward Meadows, "Our Flawed Inflation Indexes," *Fortune*, 24 April 1978, p. 67.

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